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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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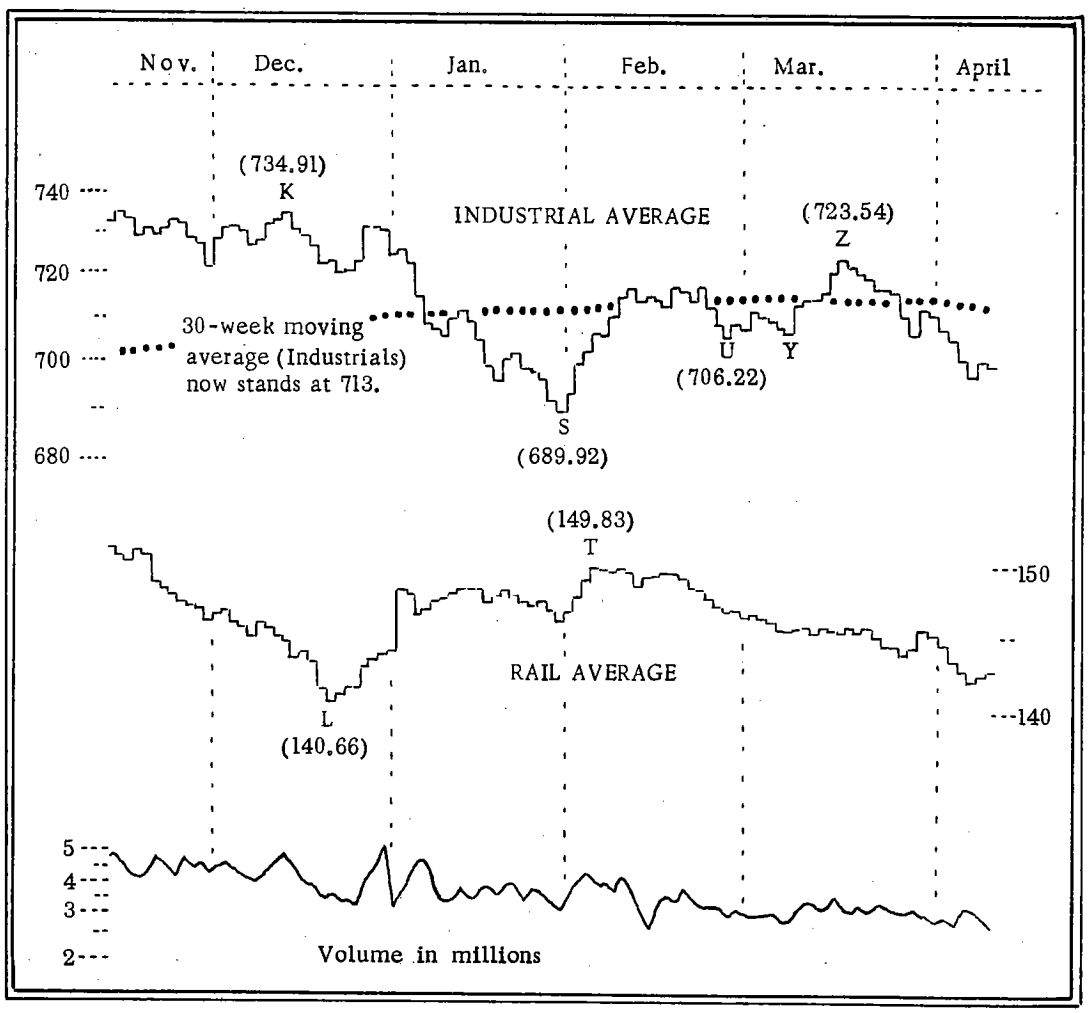
THE MARKET The decline which began in early February for Rails (T) and mid-March for Industrials (Z) accelerated last week. April 4 saw the senior Average halt within 7 points of its January low (S-689.92). The same day brought the Rail Average within 2 points of its December low (L-140.66).

Odd-lot shorts held to unusually low figures during the decline. At no time since Z have daily odd-lot short totals run to as much as 4,000 shares. On the recent low day (April 4) shorts actually dropped to 2,600 shares. Moreover, odd lot transactions have shown no trend to increased selling on the decline. When a bottom is reached, the probabilities favor odd-lot short totals in excess of 5,000 shares per day and a definite increase in odd-lot selling.

The question might be asked -- what would a joint breaking of the January low on Industrials (689.92) and the December low on Rails (140.66) mean? The December-January Industrial decline wiped out 26% of the entire 1960-61 rise on the senior Average. The October-December Rail decline erased 41% of the entire 1960-61 Rail rise. In both duration and extent, the two declines qualify as secondary reactions (although the Industrial decline was sub-normal in extent).

The subsequent Rail recovery into February and the Industrial recovery into March must be considered full corrections of the preceding reactions. Therefore, the December-January reaction lows could have primary significance.

It is my opinion that volume will be the deciding factor if we go through the reaction lows. If the two Averages break their lows on relatively low volume (say four million shares or less) it seems to me that we would have to call the move an extension of a secondary reaction.



However, if both Averages break their lows on high or liquidating volume (say six million shares or more) this writer could make out an excellent case for a change in the primary trend from bull to bear.

Downside volume indications to this point, however, definitely suggest that the decline is part of a continuing secondary reaction. Volume of below 3.4 million shares per day has characterized the drop so far, and this is not the kind which is associated with liquidation of the bear market variety.

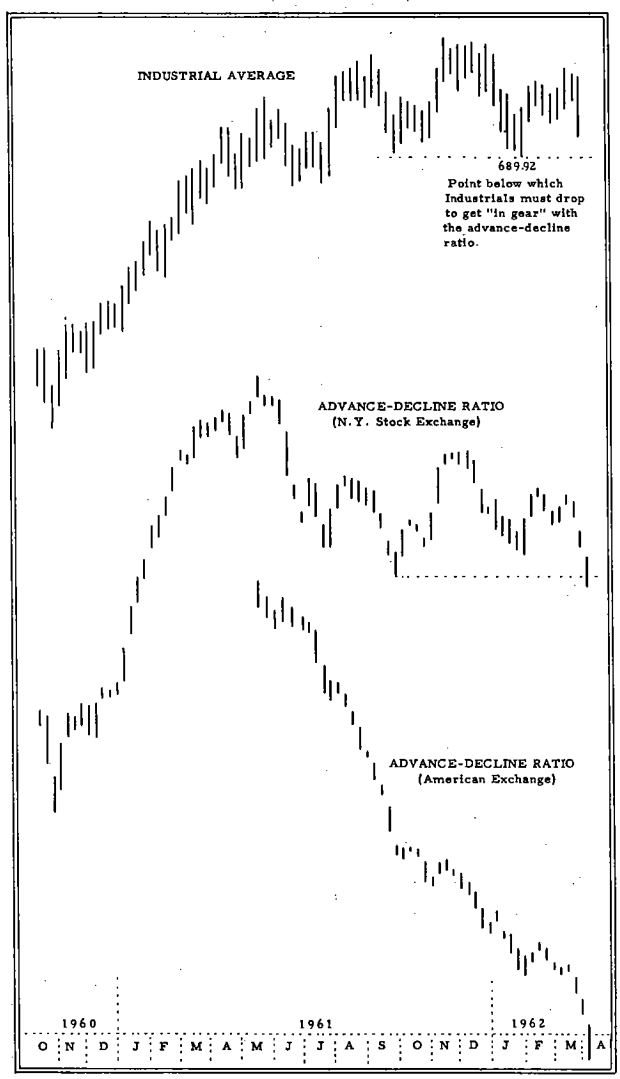
AN OPEN MIND Whatever this observer thinks or knows goes into these Letters. I possess no "professional secrets" or "systems" (perhaps unfortunately), and I am just as anxious as the next man to make money in the market. I am also aware of the fact that perpetual bullishness is considered "good business"; nevertheless, I prefer to call them as I see them. This is not always a happy procedure, but as readers of this Letter will note, I can change as fast as the market allows me to change.

I have not liked the technical situation in the market for many months, and my reasons have been presented to subscribers in detail. Since May of 1961, Industrial rallies have been accompanied by non-confirmations on the part of the advance-decline ratio, and declines in the A-D ratio have not been confirmed by Industrials. Past history shows that since 1949, all such protracted price-breadth "stalemates" have ended with Industrials and the A-D ratio getting "in gear" by breaking to new lows for the entire trading range.

This meant that if a new major advance was to begin, Industrials would first have to clear the air by breaking to new lows (as opposed to the view that they merely had to advance to record highs). Up to recently, this did not seem to be "in the cards". But last week, as the threat of a triple divergence was eliminated and as Industrials headed down, the final solution of the technical problem loomed as a very distinct possibility.

The accompanying chart brings the price-breadth picture into focus. On April 4 (last week) the A-D ratio broke below its September, 1961 low, to the lowest level since January, 1961. The same day saw Industrials stop within seven points of confirming (i.e. confirming by dropping under their own January low of 689.92).

The chart also pictures the extraordinary decline of the A-D ratio on the American Exchange. The action on the junior Exchange might politely be referred to as a protracted collapse in speculative sentiment.


INDUSTRIAL AVERAGE
689.92
Point below which Industrials must drop to get "in gear" with the advance-decline ratio.
ADVANCE-DECLINE RATIO (N.Y. Stock Exchange)
ADVANCE-DECLINE RATIO (American Exchange)
1960
1961
1962
O N D J F M A M J J A S O N D J F M A

SPECTACULAR REVERSAL POSSIBLE Subscribers who have held light positions or accepted my premise that this is "a market for traders only" were probably smirking last week as the advance-decline ratio "fell out of bed" and many stocks dropped precipitously. However, I want to warn subscribers that this may well not be the time for bearish complacency. One of the most difficult market procedures is changing one's mind quickly when events change. I therefore urge readers to read the following with an open mind, for we are drawing near to what could be a dramatic change in the market.

(1) The odd-lotters have been on the selling side of the market (with the exception of four short periods) since November, 1960. For sixteen months the public has been turning its "chips" back to Wall Street. This is a long-term bullish factor.

(2) The bank credit figures (Bolton-Tremblay and Harding Index) show a strongly bullish money situation. These men

have been extremely good on long-term trends; I never discount what they say.

(3) National magazines are now proclaiming "the end of inflation" (see U. S. News & World Report this week). The public is being told that savings are now attractive and that the stock market is past its glory. Personally, I don't like the magazines telling me what is going to happen -- they're too seldom right.

(4) The broad collapse of many stocks on the over-the-counter market, the American Exchange and the New York Stock Exchange has cast a cloud over "the cult of equity". Moreover, the clouds have been considerably thickened by a steady stream of Government investigations into the markets, the men behind the markets, and the companies themselves.

(5) The recent Industrial decline below 706.22 (see last Letter) "washed-out" a potential triple-divergence between Industrials and the A-D ratio. Yet all bear markets and severe reactions since 1919 have started with triple divergences.

(6) If Industrials drop below the January, 1962 low of 689.92 (see last Letter) the bearish series of long-term non-confirmation between price and breadth will finally have been eliminated. It has been this divergence (or series of non-confirmations) which has held the market in check for the past year. In other words, an Industrial penetration of the 689.92 level could "clear the air" for a technical reversal (I am assuming that an Industrial breaking of the 689.92 level will not be accompanied by huge or bear market-type volume).

(7) If Industrials do drop below 689.92 (and the lower the better) we will have the beginning of the first thoroughly "sold-out" market condition since October, 1960! With the A-D ratio and Industrials back "in gear", the bank credit situation and the odd-lot situation bullish, and the public definitely bearish, I believe the ground may be set for a substantial and even spectacular rise!

CONCLUSION: If Industrials drop below 689.92 without heavy liquidating-type volume this will mean that the secondary reaction which began late last year is being extended (and not that a bear market has started). A further decline below the 689.92 level could develop into the last great buying opportunity of this bull market.

Such action (i.e. a drop below 689.92) would mean that the market was finally entering the strongly over-sold area. The rise which could result from such a situation (with the A-D ratio and Industrials back in gear) could be extremely profitable -- it would in all likelihood be accompanied by broad breadth and a surging Industrial and Rail Average!

The potential "buy-spot" (if we are to get one) will probably come with a final sweeping decline in the Industrial Average. Such a drop will have the effect of "filling the vacuum" created by the recent collapse of the A-D ratio below the September, 1961 low. Stocks should be bought on such a drop, and it might be well to remember that the lower the Industrials fall, the more sold-out the market situation, and the better the buying area. Readers might remember that every ten point drop from here is ten points nearer the bottom and bearishness should be tempered (not increased) as the market retreats.

I urge readers not to try to justify forthcoming action on the basis of newspaper stories, advice from friends or fundamentals in general. After all, the fundamentals were good all through 1961, and the market did not respond. The fundamentals are now less attractive, but the technical situation is at last becoming interesting.

STOCKS Assuming we get our sold-out market (below the 689.92 level), the question becomes -- which stocks to buy? Obviously one of the first groups to consider is the group which has resisted the general market weakness for almost a year -- the D-J Industrial Stocks. Of the thirty issues which make up the Industrial Average, fourteen are now technically bullish. These fourteen stocks are listed, and after each stock is the figure which, if broken, would change the stock's listing to the bearish catagory: Alcoa (57), Am. Can (42), Am. Tel & Tel. (126), Eastman Kodak (100), Gen Motors (52), Int. Harvester (48), Int. Paper (33), Owens Illinois (82) , Sears Roebuck (77), Standard of Calif. (52), Standard of N. J. (42), Swift (38), Texaco (52), United Aircraft (44).

Of the bullish fourteen Dow Stocks the following five are the strongest: Standard of California, Standard of Jersey, American Can, Int. Paper, Gen. Motors.

Following a decline, says the old Wall Street adage, "buy the ones that go down the most and buy the ones that go down the least". There is a good deal of wisdom in this -- particularly if such stocks can be bought at important turns. The rationale for buying the weakest and the strongest stocks is as follows: after a substantial market drop the "collapses" are usually ready for technical recoveries, and the stong stocks which have been accumulated during the period of general market weakness are ready to make their upward moves.

To illustrate, between 1960 and last week Texas Instruments dropped from 256 to under 80. This represents a loss (see chart) or better than two-thirds of its value. The drop was executed in the oft-seen series of three distinct downward swings. Given an important turning point in the general market, the probabilities favor TXN going into a substantial upward correction. The risk of buying this company would seem to be limited -- with excellent probabilities of profits.

The weekly chart of Central & South West shows a stock that is strong and holding out against the broad market weakness. I would buy this stock at or near the turn for a "breakout" above the 48 top.

Following stocks are looking strong and may be bought at the bottom: Abbott Labs., Merck, Central & South West, plus the five Dow stocks listed above. Subscribers who do not want to be bothered at all about "picking" the winners might purchase shares in a closed-end trust such as Tri-Continental. This stock can be expected to keep up or perhaps even perform better than the market on an advance.

Charts on this page courtesy of Traders Research, P. O. Box 2644, St. Louis 16, Mo.

Written Monday, April 9, 10 A.M.